

Summary of Current System

	Pillar 1	Pillar 2	Pillar 3
Type:	♦ Defined-contribution	♦ Defined-contribution	♦ Defined-contribution
Participation:	♦ Mandatory	♦ Mandatory	♦ Voluntary
Management:	♦ Publicly-managed	♦ Privately-managed	♦ Privately-managed
Financing:	♦ PAYGO	♦ Fully-funded	♦ PAYGO
Coverage:	♦ Wage and salary earners, self-employed, and rural workers	♦ Wage and salary earners, self-employed, and rural workers	♦ Wage and salary earners, self-employed, and rural workers
Eligibility:	♦ Age 60 for men or age 56 for women and fulfilled minimum contribution	♦ Age 60 for men or age 56 for women and fulfilled minimum contribution	♦ Age 60 for men or age 56 for women and fulfilled minimum contribution

Challenges Facing Pension System

- ☐ Participation in shadow economy
- ☐ Demographic shifts

Summary of Current Pension System

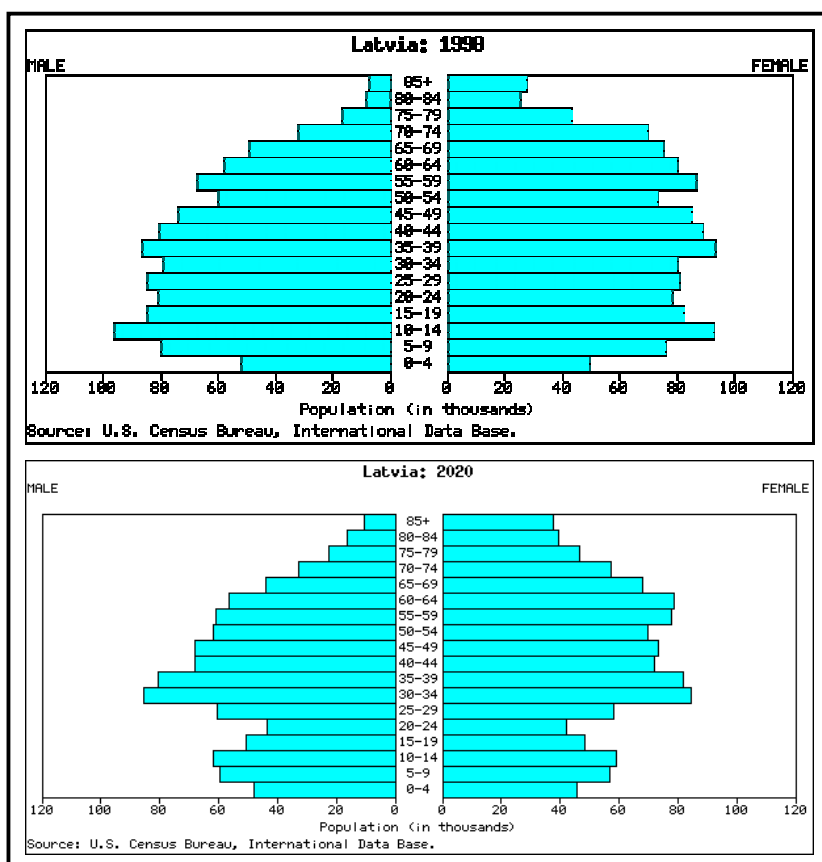
Latvia was one of the first countries in the Central and Eastern European (CEE) region to reform its public pension system. Reform of the pension system was included in a package of social insurance legislation passed in 1995. The new Latvian system features a multi-pillar pension system for workers who retire after 1995 (current pensioners were unaffected by reform efforts). Pension reform will take place in stages. Reform of the previous pay-as-you-go (PAYGO) system began in January 1996, and the second pillar will begin implementation in 1999.

The first pillar is a modified PAYGO system, emphasizing strong links between contributions and pension benefits. Modeled after the Swedish pension system, the reformed PAYGO structure is a “notional defined-contribution” scheme. Individual accounts are established, contributions are tracked, and interest is earned at an annual rate equal to the growth in covered wages. At retirement, individuals receive benefits based on the accumulated balance (including accrued interest) divided by the average post-retirement life expectancy. Pension benefits are also adjusted for inflation. The reformed system encourages individuals to continue working because pension benefits increase as contributions are placed into their account.

The second pillar consists of mandatory contributions to individual, privately-managed pension accounts. Employees will have the option of assigning a portion of their PAYGO contributions to the second pillar. Finally, the third pillar

features voluntary, private pension accounts for those wishing to save more for retirement. Legislation for the provision of private pension funds was passed in July 1997. Private pension funds are in the process of being licensed. It is expected that new entrants to the labor force will receive one-third of their pension benefits from these funded pillars.

The Latvian pension system covers the wage and salary earners, entrepreneurs, and rural workers. Contributions to the social insurance fund total 37 percent, with employers committing 28 percent of payroll and employees contributing 9 percent of their wages. In 2001, contributions to the social



SELECTED INDICATORS

Demographic	Year	
	1998	2020
Total Population (in thousands)	2,385	2,030
Life Expectancy at Birth (Years)	67.1	73.7
Total Fertility Rate (Child Born per Woman)	1.2	1.5
Age Dependency Ratio (percent)	34.0	43.0
	1980-2000	2000-2020
Average Annual Rate of Population Growth (percent)	-0.4	-0.7

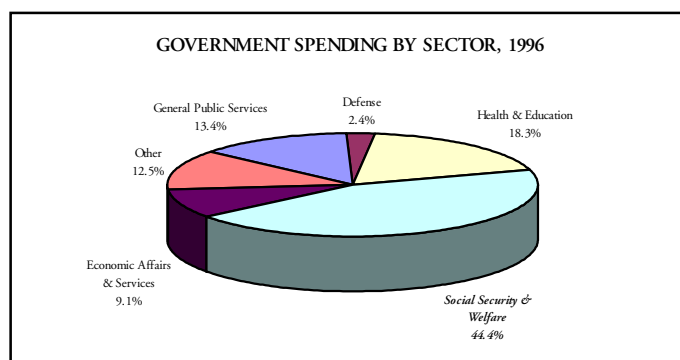
Source: U.S. Bureau of the Census, International Data Base.

Economic	1996
GNP (PPP in billions) ¹	9.1
GNP Average Annual Growth Rate, 1995-1996 (percent) ¹	2.4
GNP Per Capita (in PPP) ¹	3,650
Inflation Rate (percent) ²	17.6
Labor Force Participation Rate (percent) ³	54.3
Unemployment Rate (percent) ³	18.3

Source: ¹World Bank; ²IMF; ³International Labour Office.

Pension	1997
System Dependency Ratio, 1996 (percent) ¹	65.9
Employee Contribution for Pensions (percent of earnings) ²	9.0
Employer Contribution for Pensions (percent of payroll) ²	28.0
Public Pension Spending as % of Government Spending, 1996 ¹	28.3
Public Pension Spending as % of GDP, 1996 ¹	10.8

Sources: ¹de Castello Branco (1998); ²U.S. Social Security Administration.



Source: International Monetary Fund, Government Finance Statistics Yearbook, 1997.

insurance fund will decrease to 33 percent, accompanied by a more equitable contribution between employees (15 percent) and employers (18 percent). These contributions finance old age as well as sickness and maternity, work injury, and unemployment benefits.

The minimum retirement age is 60 years for men and 56 years for women, with 10 years of qualifying contributions. The retirement age for women will gradually increase each calendar year by six months until their retirement age also reaches 60 years. At the minimum retirement age, employees who have not met the contribution period are eligible for the minimum state pension.

Challenges Facing Pension System

After gaining independence in 1991, the government realized that the social protection system inherited from the Soviet Union would not be sustainable with expenditures increasing and revenues decreasing. Like its counterparts in the region,

Latvia's population was aging. About 650,000 individuals (or about 25 percent of the population) received benefits in 1996. During the transition period, pension expenditures increased to almost 11 percent of GDP in 1996. The system dependency ratio remained high at 90 percent, indicating that about one current worker supports a single pensioner.

A shrinking revenue base also posed a problem faced the pension system. This was in part caused by an increase in the number of pensioners, which, with its resulting increase in payroll contributions to support more pensioners provided little incentive for workers to participate in the formal economy. When reform efforts were initiated in 1996, the Central Statistical Bureau in Latvia estimated that the shadow economy accounted for 14 percent of the country's GDP.

Pension Reform Efforts

Passed in 1997 and effective in January 1998, the private pension fund law regulates the development of private pension funds. Licensed banks, life insurance companies and brokerages or investment companies will be able to operate private pension funds. The State Insurance Supervision Inspectorate provides the regulatory oversight for these funds.

Latvia is also improving the administration of its social insurance system. The improvements include the introduction of new technology for social insurance administration and training of employees to improve the monitoring and administration of benefits. The Social Security Agency (the central social insurance agency) is improving its efforts to educate the public regarding the new pension system.

A related area in the process of being reformed is the financial institutions sector. In 1995, the banking crisis culminated in the failure of the largest bank, *Banka Baltija*, in the Baltics. The crisis was caused by rapid development of the banking sector and inadequate regulatory oversight. While oversight has improved, public distrust of the financial institutions sector remains. Regaining trust in the banking system will be important in development of private pension funds.

Pension Reform Efforts by Pillar

	Pillar 1	Pillar 2	Pillar 3
Papers issued on state of pension systems	✓	✓	✓
Formulation of proposals	✓	✓	✓
Development of draft legislation	✓	✓	✓
Introduction of legislation by parliament	✓	✓	✓
Review of legislation by parliament	✓	✓	✓
Passage of legislation by parliament	✓	✓	✓
Implementation of legislation	✓		